

103 KAR 16:400. Combined Unitary Kentucky corporation income tax return.

RELATES TO: KRS 141.120, 141.121, 141.202

STATUTORY AUTHORITY: KRS 131.130(1), 141.050(4)

NECESSITY, FUNCTION, AND CONFORMITY: KRS 141.202 establishes the general rules for combined unitary reporting in Kentucky. KRS 131.130(1) authorizes the Department of Revenue to promulgate administrative regulations necessary to administer and enforce Kentucky's tax laws. KRS 141.050(4) requires the Department of Revenue to promulgate administrative regulations and rules necessary for the proper administration of KRS Chapter 141. This administrative regulation establishes terms and procedures required for the implementation of combined unitary reporting in KRS 141.202.

Section 1. Definitions. (1) "Combined group" is defined by KRS 141.202(2)(a).

(2) "Corporation" is defined by KRS 141.202(2)(b).

(3) "Designated Filer" means the taxpayer member of the combined group annually designated per KRS 141.202(9) to file the return.

(4) "Person" is defined by KRS 141.010(24).

(5) "Taxpayer" is defined by KRS 141.202(2)(e).

(6) "Unitary Business" is defined by KRS 141.202(2)(f).

Section 2. Fifty (50) Percent Ownership Test. Separate corporations may be part of a combined group only if they meet the fifty (50) percent ownership test in KRS 141.202(2)(a).

(1) The fifty (50) percent test shall be satisfied in the following circumstances:

(a) A parent corporation and one (1) or more corporations or chains of corporations which are connected through voting stock ownership with the parent, whether the ownership is direct or indirect, but only if:

1. The parent owns more than fifty (50) percent of the outstanding voting stock of at least one (1) corporation; and

2. If applicable, more than fifty (50) percent of the outstanding voting stock of each of the corporations, other than the parent, is owned by the parent, one (1) or more corporations owned by the parent as described in subsection (1) of this section, or one (1) or more corporations that satisfy the conditions of this subparagraph;

(b) Any two (2) or more corporations, if over fifty (50) percent of the outstanding voting stock of each of the corporations is owned, or indirectly owned, by the same person; or

(c) Any two (2) or more corporations, over fifty (50) percent of whose voting stock is cumulatively owned (without regard to the indirect ownership rules described in subsection (2) of this section) by, or for the benefit of, members of the same family. Members of the same family shall be limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.

(2) Except as otherwise provided in this section, voting stock is "owned" if title to the stock is directly held or if the voting stock is indirectly owned. The stock attribution rules of Section 318(a) of the Internal Revenue Code, 26 U.S.C. 318(a), shall be used to determine if the voting stock is indirectly owned except if a person has an option to acquire stock or other ownership interests in an entity, the stock or ownership interests are not considered owned by the person unless the department determines it to be necessary to prevent tax avoidance.

(3) In determining ownership, effective control over election of the board of directors shall be considered. For example, a group of shareholders acting in concert who collectively own over fifty (50) percent of the voting stock of each of two (2) or more corporations shall be considered to be common owners of more than fifty (50) percent of the voting stock of each of

those corporations. "Voting stock" refers only to those shares of voting stock having the power to elect the corporation's board of directors. If the power otherwise held in corporate stock to vote the membership of the board is transferred to another, other than a transfer of proxy only, the holder of that power shall be considered to be the owner of that stock to the exclusion of the transferor of that power.

(4) In addition to the tests in subsection (1) of this section, the department may consider any other circumstance that tends to demonstrate that the fifty (50) percent direct or indirect common ownership test was met, or was not met.

(5) Membership in a combined group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subsection (1) of this section are not met, except as follows:

(a) If stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a combined group shall not be terminated if the requirements of subsection (1) of this section are again met immediately after the sale, exchange, or disposition.

(b) The department may treat the combined group as remaining in place if the conditions of subsection (1) of this section are again met within a period not to exceed two (2) years.

Section 3. Unitary Business Principle. (1) The concept of a Unitary Business.

(a) The flow of value to an entity located in this state that comes from being part of a unitary business conducted both within and without this state is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion apportionable income of the unitary business, even if that income arises in part from activities conducted outside the state.

(b) This sharing or exchange of value may also be described as:

1. Requiring that the operation of one (1) part of the business be dependent upon, or contribute to, the operation of another part of the business: or

2. If the activities of one (1) business either contribute to the activities of another business or are dependent upon the activities of another business, those businesses are part of a unitary business.

(2) Constitutional requirement for a Unitary Business.

(a) The sharing or exchange of value described in KRS 141.202(2)(f) and subsection (1) of this section that defines the scope of a unitary business shall require more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no operational relationship to the unitary business.

(b) In this state, the unitary business principle shall be applied to the full extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of the activities or entities would not be allowed by the U.S. Constitution.

(3) Separate trades or businesses conducted within a single entity. A single entity may have more than one (1) unitary business. In these cases, the apportionable income attributable to each separate unitary business as well as its non-apportionable income, which is specifically allocated, shall be determined. The apportionable income of each unitary business shall then be apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

(4) Unitary Business unaffected by formal business organization. A unitary business may exist within a single entity or among a group of entities meeting the fifty (50) percent ownership test in KRS 141.202(2)(a) and in Section 2 of this administrative regulation.

Section 4. Determination of a Unitary Business. (1) A unitary business shall be character-

ized by significant flows of value evidenced by factors such as functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. Facts suggesting the presence of these factors shall be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one (1) or more of the factors mentioned above.

(2) Description and illustration of functional integration, centralization of management, and economies of scale.

(a) Functional integration. Functional integration shall refer to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration shall include transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. A specific type of functional integration shall not be required. The following is a list of examples of business operations that may support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

1. Sales, exchanges, or transfers (collectively "sales") of products, services, or intangibles between business activities may provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration shall be affected by the character of what is sold or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration shall not be negated by the use of a readily determinable market price to effect the intercompany sales, because those sales may represent an assured market for the seller or an assured source of supply for the purchaser.

2. Common Marketing. The sharing of common marketing features among entities shall indicate functional integration if the marketing results in significant mutual advantage. Common marketing exists if a substantial portion of the entities' products, services, or intangibles are distributed or sold to a common customer, if the entities use a common trade name or other common identification, or if the entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office shall not by itself establish common marketing that is suggestive of functional integration. That activity, however, shall be relevant to determining the existence of economies of scale or centralization of management.

3. Transfer or Pooling of Technical Information or Intellectual Property. Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, shall provide evidence of functional integration if the matter transferred is significant to the businesses' operations.

4. Common Distribution System. Use of a common distribution system by the entities, under which inventory control and accounting, storage, trafficking, or transportation are controlled through a common network shall provide evidence of functional integration.

5. Common Purchasing. Common purchasing of substantial quantities of products, services, or intangibles from the same source by the entities, particularly if the purchasing results in significant cost savings or if the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, shall provide evidence of functional integration.

6. Common or Intercompany Financing. Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one (1) or more entities for the bene-

fit of another entity or entities shall provide evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender shall not necessarily provide evidence of functional integration.

(b) **Centralization of Management.** Centralization of management shall exist if directors, officers, or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management may exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one (1) subsidiary entity to another, from one (1) division within a single entity to another division within an entity, or from any combination of the foregoing. Centralization of management may exist even if day-to-day management responsibility and accountability has been decentralized, if the management has an ongoing operational role with respect to the business activities. An operational role may be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

1. **Facts Providing Evidence of Centralization of Management.** Evidence of centralization of management shall be provided if common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist if management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, shall not alone provide evidence of centralization of management. Common officers may be more likely to provide evidence of centralization of management than are common directors.

2. **Stewardship Distinguished.** Centralized efforts to fulfill stewardship oversight shall not provide evidence of centralization of management. Stewardship oversight shall consist of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight shall be distinguished from those activities that an owner may take to enhance value by integrating one (1) or more significant operating aspects of one (1) business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.

(c) **Economies of Scale.** Economies of scale shall refer to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that may support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.

1. **Centralized Purchasing.** Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing shall provide evidence of economies of scale.

2. **Centralized Administrative Functions.** The performance of traditional corporate administrative functions in common, such as legal services, payroll services, pension and other employee benefit administration, among the parts of the business may result in some degree of economies of scale. An entity that secures savings in the performance of corporate administrative services due to its affiliation with other entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, shall

provide evidence of economies of scale.

Section 5. Indicators of a Unitary Business. (1) same type of business. Business activities that are in the same general line of business shall generally constitute a single unitary business, as, for example, a multistate grocery chain.

(2) Steps in a vertical process. Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.

(3) Strong centralized management. Business activities that might otherwise be considered as part of more than one (1) unitary business may constitute one (1) unitary business if there is a strong central management, coupled with the existence of centralized departments for functions such as financing, advertising, research, or purchasing. Strong centralized management shall exist if a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one (1) unitary business if the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

Section 6. Taxable Year of the Combined Group. The combined group's taxable year shall be determined as follows:

- (1) If two (2) or more members of a group file a federal consolidated return, the combined group's taxable year shall be the taxable year of the federal consolidated group; or
- (2) In all other cases, the taxable year shall be the taxable year of the designated filer.

Section 7. Members with Different Accounting Periods. (1) If the taxable year of a member differs from the taxable year of the combined group, the designated filer shall elect to determine the portion of that member's income to be included in one (1) of the following ways:

- (a) A separate income statement prepared from the books and records for the months included in the combined group's taxable year; or
- (b) Including all of the income for the year that ends during the combined group's taxable year.

(2) Except as provided by subsection (3) of this section, the same method shall be used for each member with a different accounting period. Once an election is made under this section by attaching a statement to the return, it shall be the only method that may be used with respect to members of the combined group.

(3) A designated filer may request to change the method in subsection (1) that is used to determine the portion of a member's income to be included in a combined group by utilizing the method to petition for alternative apportionment as established in 103 KAR 16:330.

Section 8. Designated Filer. Responsibilities of designated filer.

(1) Access to records. In addition to the information required to be included in the combined group return, upon request of the department, the designated filer shall provide access to:

- (a) The tax and financial records of members of the combined group that are part of the

combined group but do not have Kentucky nexus; and

(b) Non-financial records of the combined group.

(2) Filing. The designated filer shall file a combined group return on behalf of the combined group together with all returns and schedules required by the Department.

(3) Payment. The designated filer shall timely remit to the department the Kentucky corporate income and limited liability entity tax imposed on the combined Kentucky net income and receipts of the combined group.

(4) Notices. Notices mailed to the designated filer shall be deemed to have been mailed to each of the members in the combined group. (46 Ky.R. 286, 875, eff. 10-4-2019.)